

This section describes investment instruments used by the King County Finance Division. The rationale for purchase, the criteria for selection and the limitations on the use of each type of security are summarized. All investment instruments selected comply with the terms of RCW 36.29.020.

| <u>Section</u> | <u>Subsection Number</u> |
|--|-------------------------------------|
| Certificates of Deposit | 90.1 |
| Bankers' Acceptances | 90.2 |
| U.S. Treasury and Agency Obligations | 90.3 |
| Repurchase Agreements | 90.4 |
| Zero Coupon Bonds and Stripped Coupons | 90.5 |
| Commercial Paper | 90.6 |
| Reverse Repurchase Agreements | 90.7 |
| Local Government Investment Pool | 90.8 |
| Municipal Bonds | 90.9 |
| Mortgage-Backed Securities | 90.10 |
| Bank Notes | 90.11 |
| Selecting an Investment Instrument | 90.12 |

Description

Certificates of Deposit (CDs) are time deposits in banks and thrift institutions with fixed dates of maturity ranging upward from seven days. Interest on CDs is paid at maturity unless the maturity is greater than 1 year. In such cases, the County receives quarterly interest distribution from thrifts and semi-annual payments from commercial banks.

Rationale for purchase

Certificates of Deposit are readily available, come in a wide range of maturities, and can be placed in any dollar amount above \$1000. Furthermore, CDs can often be placed in local thrift institutions and commercial banks which loan money to local businesses and home owners, allowing the County's money to benefit the local economy. CDs allow the County to obtain competitive rates on relatively small amounts of money.

Limitations

Certificates can be placed only with institutions that are public depositories in the State of Washington. RCW 39.58 governs public depositories and provides that the deposits of a municipal body cannot exceed the net worth of an institution.

In July 1986, the County Executive Finance Committee adopted a policy that provides for monitoring of the financial condition of commercial banks and thrift institutions. (See Section 210.2) Quarterly financial data is used to determine the maximum total deposits to be placed with each institution. In no event can total deposits exceed 100% of the institution's net worth.

Policy on Early Redemption in the Event of Failure

Because of deposit protection regulations, risk of loss of principal is minimal for investment deposits in a bank or thrift institution. However, in a bankruptcy, assets of an institution may be frozen while regulatory authorities ascertain account balances and liabilities. If a CD matures during that time, cash flow problems may result or the opportunity to reinvest those funds may be lost.

If a bank or thrift institution should fail, or the Executive Finance Committee has reason to believe it may fail, King County generally does not withdraw a CD prematurely and suffer the substantial interest penalty for early redemption. The County only redeems a CD prior to its maturity if there is not reasonable assurance that the principal amount will be recovered from FDIC or FSLIC insurance, or Public Deposit Protection Commission collateral.

Penalty for Overinvestment in Certificates of Deposit

If any County or junior taxing district fun needs the cash in a CD prior to its maturity, an interfund purchase of the CD may be made. The procedure for interfund purchases is described in Section 70.5.

90.2

Bankers' Acceptances

Description

Bankers' Acceptances (BAs) are created to finance self-liquidating transactions between buyers and sellers of goods. A bank issues a letter of credit on behalf of the buyer, which the seller uses to obtain payment for the goods. The seller's bank then presents this letter of credit to the issuing bank, which "accepts" the obligation to pay the seller's bank on a specified date, with accrued interest. The obligation to pay this draft becomes an irrevocable commitment, which can then be sold on the secondary market as an investment instrument. Bankers' Acceptances are sold at a discount, and are subject to Federal Reserve requirements.

Since their inception in 1913, there has never been a failure of a BA. They are issued in maturities up to 180 days and are traded actively on the secondary market. They thus provide the County with a safe, liquid, short-term investment.

State law requires that BAs can be purchased only on the secondary market. County policy further limits that any BA purchased must be issued by the top 50 world banks in terms of assets as listed by American Banker or by approved domestic banks (see Section 210.4).

90.3

Treasuries and Agencies

Description

Treasury Bills, notes and bonds (T-bills, T-notes, and T-bonds, or “Treasuries”) are direct debts of the U.S. Government, which it issues in order to meet its obligations. Their purpose is to finance the gap between the government’s disbursements and its receipt of revenues.

Treasuries are considered the safest of all investments. They are backed by the full faith and credit of the U.S. Government, meaning that the government commits its taxing authority, and more importantly, its power to print money to redeem the bills and notes, if necessary. Because they are considered risk free, Treasuries generate a low return relative to most other investments. However, the absence of risk also makes treasuries readily saleable on the secondary market.

“Agencies” are securities issued by agencies of the federal government to finance their operations. Agencies are not direct obligations of the federal government, and are therefore not backed by its full faith and credit. They are nonetheless considered secure investments because of the agencies’ right to borrow from the U.S. Treasury to meet their obligations. Because they are considered somewhat less secure than treasuries, agencies tend to offer slightly better interest rates.

Although treasuries and agencies have yields lower than other money market instruments, they can afford protection during periods of declining interest rates. By purchasing some intermediate length treasuries and agencies in the 1-5 year area, as well as short-term investments under 6 months, the County is able to realize a better overall return.

Description

Repurchase Agreements (“Repos”) are short-term investment instruments in which the buyer purchases a security for cash, and simultaneously agrees to sell back the security to the seller, on a specified date for a specified price which includes interest. Repos are available for any maturity and amount, which enables the County to match specific maturity requirements.

Because of this flexibility, repos are King County’s primary instrument for very short-term investments, such as overnight.

Limitations on Use

1. King County may not enter into repurchase agreements for periods of more than 60 days.
2. The underlying security in a repo transaction must be an investment authorized in RCW 36.29.020. The County will further restrict the underlying securities used for those junior taxing districts that might have other statutory or policy restrictions.
3. All underlying securities used in repurchase agreements are purchased Delivery vs. Payment (DVP). These securities are delivered to the County’s safekeeping bank or its New York agent.

Valuation of Underlying Securities

The purchase price of the repo is based upon the market value of the underlying security. However, the market value will fluctuate during the term of the repurchase agreement if interest rates change. To protect the County in the event of a failure to repurchase (in which case the County will need to sell the underlying security on the open market to recover its investment), securities with greater value than the purchase price must be transferred to the County at the time the repurchase agreement is entered into. The purpose of this extra value (known as a “haircut”) is to guard against a decrease in the market value of the security below the repurchase price the County has contracted to receive.

Securities purchased by King County on repo transactions must have a market value equal to 102% of the purchase price for terms of 1 to 30 days and 105% for terms in excess of 30 days. The haircut is designed to protect the County from being under collateralized. Should the market value of the securities decrease below the book value of the repo, additional securities of a similar type must be provided.

Master Repurchase Agreement Contract

A master repurchase agreement contract which clearly defines the responsibilities of both buyer and seller has been developed by King County (see Section 210.5). The County requires that all dealers sign the contract before they are allowed to do business with the County.

Description

Zero-Coupon Bonds and Stripped Coupons (both known as STRIPS, for Separate Trading of Registered Interest and Principal of Securities), result from the separation of a T-note or bond and its interest coupons into independent investment instruments.

The note or bond, called the corpus, is sold at a discount, with the face value received on the date of maturity for that note or bond. Each interest coupon is also sold at a discount.

STRIPS are sold by securities dealers who have purchased the T-notes or T-bonds and created the strips. There is an active secondary market for them, although there has not been universal acceptance by the investment community. They are extremely interest-rate sensitive and should be avoided for all but debt service type funds.

Rationale for Use

STRIPS are useful in circumstances in which a guaranteed reinvestment rate is advantageous and safety is paramount. They are used primarily to defease bond issues of King County or its junior taxing districts, or when a large payment, such as a lease purchase agreement, will be made at a future date.

Generally, money earmarked for debt service on bonds is invested at the then prevailing interest rates. If interest rates decrease, there is a possibility that the return on the investment will be insufficient to satisfy the debt service requirement. STRIPS eliminate that uncertainty by locking in a reinvestment rate on semi-annual interest payments.

If debt service and principal payments are guaranteed, a bond issue will be deemed to be defeased. Defeasance enables the bond issuer to eliminate the debt from its books. This has two advantages. First, it eliminates the bond issue debt from the balance sheet. This is particularly important if the County or junior taxing district is near its debt limit. Second, it generally automatically results in a AAA/Aaa rating for that bond issue. This positively affects the issuer's bond rating on future debts. The higher the bond rating, the lower the rate of interest the issuer will have to pay on its debt.

Additionally, STRIPS are backed by the full faith and credit of the U.S. Government, because the investment instruments are actual T-notes, bonds or interest coupons. Moreover, the return on STRIPS has been higher than on T-notes or bonds of the same maturity.

State and Local Government Series Bonds

An instrument that is somewhat similar to the zero coupon bond is the State and Local Government Series Bonds (SLGS). These instruments are created by the Federal government and are sold at restricted yields in order to satisfy arbitrage restrictions.

SLGS are purchased whenever there is a need to restrict the investment earnings of a particular debt issue. They are sold to mature on any date, which allows the investor to exactly meet any maturity requirement. The Federal Reserve publishes a weekly rate sheet which establishes a maximum interest rate for each maturity sector. The investor, through an application process, purchases the SLGS at or below the published rate.

Description

Commercial Paper (“CP”) is a short-term investment instrument issued by a bank, finance company, industrial company, or municipality. Commercial Paper may be offered in maturities of 1-270 days, but most offerings are 30-180 days. Commercial Paper is usually sold at a discount.

The Commercial Paper market has thousands of issuers, so investors depend on rating agencies to determine the credit quality of each issuer. Rating agencies generally rate Commercial Paper at three levels, with “1” being the highest credit and “3” being the lowest. Nationally recognized rating agencies include Standard & Poors, Moodys, Duff & Phelps, and Fitch. Rates on Commercial Paper are competitive with those of BAs, but Commercial Paper has the advantage of smaller minimum and incremental purchases.

Limitations

1. Purchases must be rated with the highest short-term credit ratings of any two nationally recognized rating agencies at the time of purchase. If the Commercial Paper is rated by more than two rating agencies, it must have the highest rating from all organizations.
2. Purchases are limited to 5% of any one name in any portfolio. State law requires that Commercial Paper be purchased only from dealers.
3. Purchases are limited to maturities of 180 days.
4. Purchases of greater than 100 days must also have an underlying long-term rating of one of the two highest credit ratings of a nationally recognized rating agency.

Description

A reverse repurchase agreement (“reverse”) is an investment transaction in which securities in the County’s portfolio are sold and an agreement is made to buy back the securities at a later date. This agreement discloses a repurchase price, which would include a specified interest rate that is applied against the original proceeds. Although reverses can be used as a borrowing mechanism, the proceeds are generally reinvested in another instrument to a date similar to the maturity of the reverse. The new instrument provides a greater rate of return than the rate paid on the reverse.

Limitations on Use

1. King County will not use reverse repurchase agreements to borrow funds for any purpose.
2. King County will use only reverses that are “match book” transactions. A match book means that the maturity date of the acquired security is identical to the end date of the reverse.
3. King County will enter into reverse repurchase agreements only with firms with which they have adopted a master repurchase agreement. (see below)
4. King County will not enter into a reverse repurchase agreement for periods exceeding 180 days.
5. King County will not reverse more than 20% of the total balance of the Investment Pool at any one time.

Master Repurchase Agreement

A master repurchase agreement contract which defines the responsibilities of both parties has been developed by King County. The County requires all firms to sign the agreement before being allowed to do repos/reverses with the County.

Procedures

King County makes available on-line a listing of its portfolio to firms authorized to do business with the County. These firms periodically review the portfolio for swap and reverse opportunities. Investment firms show reverse rates to the County that are either at their standard posted rate or at “special” rates which are significantly lower in order to fill a need for a specific security.

The proceeds from the reverse are invested to a date identical to the end of the reverse. The security purchased is acquired the same way other securities are obtained: by

soliciting offers and accepting the best. King County is not obligated to buy the new security from the same firm with which the reverse is placed.

Ordinarily, the County will reserve the right to substitute similar securities during the life of the reverse. This allows maximum flexibility for the Investment Officer should another opportunity occur.

The Local Government Investment Pool (LGIP) is a short maturity investment pool run by the State of Washington and available to all government entities in the state. King County may occasionally invest in the pool when the LGIP rate is higher than prevailing interest rates. The LGIP is limited to purchasing securities allowed by Washington State law which include government securities, certificates of deposit and repurchase agreements.

Description

A municipal bond is a debt instrument of a state or local governing body which is issued to meet financial obligations. Municipal bonds are rated by various agencies who determine the creditworthiness of the issuer. Because municipal bonds carry a slight credit risk, they return a higher yield than a treasury or agency security.

Limitations on Use:

1. King County will purchase only bonds of the state of Washington and any local government of the state of Washington; or, general obligation bonds of a state other than the state of Washington and general obligation bonds of a local government of a state other than the state of Washington.
2. At the time of purchase, bonds must have one of the three highest credit ratings of a nationally recognized credit rating agency (i.e. "A" or better).
3. Maturity is limited to five years.

90.10**Mortgage-Backed Securities****Description**

A mortgage-backed security (MBS) is created when a group of mortgages is bundled together. The investor may receive both principal and interest monthly.

MBSs carry very low credit risk but some market risk because there is a possibility of early payment of principal. If interest rates have decreased, reinvestment of principal would occur at a lower yield. Returns on MBSs are higher than treasury or agency securities to compensate for this risk.

Limitations on Use

1. King County will only purchase MBSs issued by Federal Agencies of the United States, including, but not limited to, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal Home Loan Bank.
2. The average life of MBSs is limited to 5 years at time of purchase.
3. If Fitch Investor Services rates the issue, the MBS must be rated between V1 and V5 (on a scale ranging from V1, lowest market risk, to V10, highest market risk).
4. MBSs must pass the FFIEC (Federal Financial Institutions Examination Council) suitability test which banks use to determine lowest risk securities.

Description

A bank note is a note, bond, or debenture of a savings and loan association, bank, mutual savings bank, or savings and loan service corporation operating with the approval of the federal home loan bank, and corporate mortgage companies. Bank notes are rated by various agencies who determine the creditworthiness of the issuer. Because bank notes carry a slight credit risk, they return a higher yield than a treasury or agency security.

Limitations on Use:

1. At the time of purchase, bonds must be rated “A” or better by two nationally recognized credit rating agencies or insured or guaranteed by an agency of the federal government.
2. Maturity is limited to five years.

90.12**Selecting an Investment Instrument**

The authority for determining the appropriate investment instrument rests with the King County Finance Director, who has the statutory role of the County Treasurer. The Investment Officer makes this determination as part of the overall investment responsibility.

Several factors that affect the Investment Officer's selection of an investment security include the amount of money available for investment, the maturity requirements, and any legal or policy considerations.

Generally funds with similar maturity requirements are combined in order to buy in size and obtain the best rate available. With amounts under \$1,000,000, often the only available instrument is a Certificate of Deposit. Frequently, thrift institutions are very aggressive and pay rates that are comparable or even higher than rates available for other instruments.

When investing amounts of \$1,000,000 or more, the term of the investment affects the type of security purchased. When the term is under 60 days, the best rates available are generally bankers' acceptances, commercial paper, and repurchase agreements. Because of the ability to match exact amounts and exact dates, repurchase agreements are often used. On terms between 60 and 180 days, bankers' acceptances and commercial paper are used most frequently unless there is an aggressive CD rate available.

For terms beyond 6 months, a treasury, agency or municipal bond is selected unless a CD level sufficiently compensates for the loss of liquidity. In summary, the available securities have the following characteristics:

| | Minimum amount for Investment | Normal Increments | Accrued Interest Purchased | Delivery | Usual Term |
|----------------------------|--|------------------------------|---|-------------------|-------------------|
| Treasuries/ Agencies | 10,000 | 1,000 | Yes/No | Safekeeping Agent | Up to 5 years |
| Bankers' Acceptances | 1,000,000* | 1,000,000 | No | Safekeeping Agent | 30-180 days |
| Certificates of Deposit | 2,500 | 1,000 | No | King County | 7 days to 5 years |
| Commercial Paper | 100,000 | 1,000 | No | Safekeeping Agent | 30-180 days |
| Repurchase Agreements | 1,000,000 | 1,000 | No | Correspond Bank | 1-60 days |
| Municipal Bonds | 100,000 | 5,000 | Yes/No | Safekeeping Agent | Up to 5 years |
| Mortgage-backed | 1,000,000 | 100,000 | Yes/No | Safekeeping Agent | Up to 5 years |

| Securities | | | | average life | |
|------------|---------|-------|--------|-------------------|---------------|
| Bank Notes | 100,000 | 1,000 | Yes/No | Safekeeping Agent | Up to 5 years |

*Although generally available only in amounts \$1,000,000 and above, occasional “odd lots” are purchased.